Internal Revenue Service

Department of the Treasury

Number: **200125089**
Release Date:6/22/2001
Index Number:1362.02-03;7704.03-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2 - PLR-116608-00
Date:
March 28, 2001

X =

Property =

D1 =

D2 =

$x =

$y =

Dear :

This letter responds to a letter, dated August 11, 2000, and subsequent correspondence written by your authorized representative on behalf of X, requesting rulings under § 1362(d)(3)(C)(i) of the Internal Revenue Code.

According to the information submitted, X was incorporated on D1 and has elected under § 1362(a) to be an S corporation. X has accumulated earnings and profits.

X is in the business of owning, leasing, and managing the Property. Through X's nine full-time employees and contractors, X provides various services in leasing and managing the Property. These services include: regular property inspection; common area maintenance; janitorial services (including cleaning of the offices of various tenants); maintenance and repair of building structural components and systems; maintenance of exterior areas including parking lots, parking deck (including attendant and security), water fountain, clock tower, streets, and sidewalks; testing and maintenance of fire alarms and sprinklers; security services and alarm monitoring; landscaping and grounds maintenance; trash and snow removal; pest control; window

washing; construction and maintenance of all indoor and outdoor signs; coordination of tenant improvements; and the handling of tenant concerns and complaints.

In the fiscal year ending D2, X accrued approximately $x in rents and incurred approximately $y in relevant expenses.

To diversify its business holdings, X wants to invest in entities that operate in industries different from its own. To that end, X has identified several publicly traded limited partnerships (PTPs) engaged in the business of purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other chemical products.

X represents that the PTPs in which it is seeking to invest meet either the qualifying income exception of § 7704(c) or the electing 1987 partnership exception of § 7704(g) and, thus, are taxed as partnerships for federal tax purposes. X also represents that these PTPs are not electing large partnerships as defined by § 775 and, thus, the normal flowthrough provisions of subchapter K apply to their partners.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) terminates whenever the corporation has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and has gross receipts for each of such taxable years more than 25 percent of which are passive investment income. Any termination under this paragraph shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to above.

Section 1362(d)(3)(C)(i) provides that except as otherwise provided, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1375(a) provides that a tax is imposed on the income of an S corporation for any tax year in which the corporation has accumulated earnings and profits at the close of that year and gross receipts more than 25 percent of which are passive investment income.

Section 1.1362-2(c)(5)(ii)(B)(2) of the Income Tax Regulations provides that "rents" does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or

business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Section 702(a)(7) of the Code provides that, in determining income tax liability, each partner shall take into account separately his distributive share of the partnership's items of income, gain, loss, deduction, and credit to the extent provided by regulations.

Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under § 702(a)(1) through (7) shall be determined as if the item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Section 1.702-1(a)(8)(ii) of the Regulations provides that each partner must take into account separately his distributive share of any partnership item that would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately.

Except as provided in § 7704(c), § 7704(a) of the Code provides that a PTP shall be treated as a corporation for federal income tax purposes.

Section 7704(b) provides that the term PTP means any partnership if interests in that partnership are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 7704(c)(1) provides that § 7704(a) shall not apply to a PTP for any tax year if the partnership meets the gross income requirements of § 7704(c)(2) for that year and each preceding tax year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence.

Section 7704(c)(2) provides that a partnership meets the gross income requirement for any tax year if at least 90 percent of the partnership's gross income for that year consists of qualifying income.

Section 7704(d)(1)(E) provides that income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber) is qualifying income.

Section 7704(g)(1) provides that § 7704(a) shall not apply to an electing 1987 partnership. Section 7704(g)(2) provides that, for purposes of this subsection, the term "electing 1987 partnership" means any publicly traded partnership if (A) the partnership is an existing partnership (as defined in § 10211(c)(2) of the Revenue Reconciliation Act of 1987), (B) § 7704(a) has not applied (and without regard to § 7704(c)(1) would not have applied) to the partnership for all prior tax years beginning after December 31, 1987, and before January 1, 1998, and (C) the partnership elects the application of § 7704(g), and consents to the application of the tax imposed by § 7704(g)(3), for its first tax year beginning after December 31, 1997. A partnership that, but for this sentence, would be treated as an electing 1987 partnership shall cease to be so treated (and the election under § 7704(g)(2)(C) shall cease to be in effect) as of the 1st day after December 31, 1997, on which there has been an addition of a substantial new line of business with respect to the partnership.

Rev. Rul. 71-455, 1971-2 C.B. 318, deals with an S corporation that operates a business in a joint venture with another corporation. In the tax year at issue, the total business expenses exceeded gross receipts. The revenue ruling holds that, in applying the passive investment income limitations, the S corporation should include its distributive share of the joint venture's gross receipts and not its share of the venture's loss. In accordance with section 702(b), the character of these gross receipts were not converted into passive investment income upon their allocation to the S corporation.

X's distributive shares of gross receipts from the PTPs, if separately taken into account, might affect its federal income tax liability. Under § 1362(d)(3), the status of X as an S corporation could depend upon the character of its distributive shares of gross receipts from the PTPs. Thus, pursuant to § 1.702-1(a)(8)(ii), X must take into account separately its distributive shares of the gross receipts from the PTPs. The character of these partnership receipts for X will be the same as the character of the partnership receipts for the PTPs, in accordance with § 702(b).

Based solely on the facts and representations submitted, we conclude: 1) the rental income that X derives from Property is

income from the active trade or business of renting property and is not passive investment income as defined by § 1362(d)(3)(C)(i); 2) X's distributive share of the gross receipts of the PTPs' in which it intends to invest will be included in the gross receipts for purposes of § 1362(d)(3) and § 1375(a); and 3) X's distributive shares of the PTPs' gross receipts attributable to the purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other chemical products will not constitute passive investment income as defined by § 1362(d)(3)(C)(i).

Except as specifically set forth above, we express no opinion as to the federal tax consequences of the transaction described above under any other provision of the Code. Further, we express no opinion on whether X is eligible to be an S corporation. Further, the passive investment income rules of § 1362 are completely independent of the passive activity rules of § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 469.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely yours,

JEANNE M. SULLIVAN
Assistant to the Chief
Branch 2
Office of the Associate
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
Copy for § 6110 purposes
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